



# MONTANA LEGISLATIVE BRANCH

## Legislative Fiscal Division

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Legislative Fiscal Analyst  
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DATE: November 15, 2006

TO: Members of the Legislative Finance Committee

FROM: Barbara Smith, Fiscal Analyst

RE: DNRC Supplemental Appropriation – Diversions of Trust Revenues

There are ten land trusts held by the state and managed by the Department of Natural Resources and Conservation (DNRC) for the purpose of generating income for the trust beneficiaries. The beneficiaries include common (public) schools, the university system, and specific state institutions. Revenue is generated through land management activities such as commercial leasing, grazing, recreational use and minerals management. The cost to manage such activities is recovered from trust revenues.<sup>1</sup> Recent legislative audit findings have identified \$968,174<sup>2</sup> of inappropriate diversions of such revenues. The executive is proposing to reimburse the trusts approximately \$560,000 through a supplemental appropriation for FY 2007.

## PURPOSE

The purpose of this memo is to provide background information regarding the requests, highlight issues associated with the request, discuss the appropriateness of utilizing the supplemental appropriation process, and provide options for legislative consideration. The three specific areas associated with the supplement request are:

1. Violation of the federal Morrill Act;
2. Utilization of other trust revenues to administer the Morrill Trust; and
3. Inappropriately withheld common school revenues to cover administrative costs

## Federal Morrill Act

State trust lands were transferred from the federal government via the Enabling Act, or the Morrill Act, of 1862. Section 3 of the Morrill Act directed the expenses of the trust to be paid out of the treasury of the state. Morrill trust revenues have been utilized to manage the Morrill Trust for the benefit of Montana State University between FY 1967 and FY 2002. A total of \$507,643 was diverted by law from trust revenues during this period of time.<sup>3</sup> The legislative audit determined that the Morrill Trust or its

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<sup>1</sup> The issue of utilizing trust revenues to pay administrative costs is long standing. Greg Petesch, Director of Legal Services for the Legislative Services Division, has written numerous legal opinions regarding his concern that it is unconstitutional to withhold any amounts from the revenue from common school trusts. His opinion points out that the Montana Constitution provides that for public schools 95 percent is to be disbursed directly to the schools and that 5 percent must go into the permanent fund of the trust. There is no mention in the Montana Constitution regarding administrative costs.

<sup>2</sup> Does not include interest.

<sup>3</sup> Legislative Audit Division, Department of Natural Resources and Conservation Financial Compliance audit for the two fiscal years ended June 30, 2006.

beneficiary, (Montana State University) should be repaid the amounts that were inappropriately withheld. The proposed supplemental includes plans to repay the diverted trust revenues. However, DNRC's fiduciary duty obligates that they also repay accrued interest.<sup>4</sup>

### **Utilization of other trust revenue for Morrill Trust Administration**

In FY 2003, DNRC voluntarily stopped taking assessments against the Morrill Act trust<sup>5</sup> and the administrative costs have been absorbed by the other trusts, including other university trusts.<sup>6</sup> Figure 1 summarizes the amount of Morrill Act costs that were paid by the other trusts between FY 2003 and FY 2005. There will be additional costs associated with FY 2006 and FY 2007. As with the Morrill Trust, DNRC's fiduciary duty obligates that diverted trust revenues and accrued interest be returned to the trusts that absorbed the stopped Morrill assessments.

Figure 1 Land Trust Revenues Diverted for Morrill Trust Administration Fiscal Years 2002 through 2005	
<u>Trust</u>	<u>Total</u>
Common School	\$191,945
Montana State University - 2nd Grant	12,874
University of Montana	5
Montana Tech	678
State Normal School	5,388
School for the Deaf & Blind	660
State Reform	7,502
Capital Building	<u>25,848</u>
	<u><u>\$244,900</u></u>

The supplemental appropriation request includes \$52,955 of these diversions. However, it does not include a repayment to common schools and it does not provide for interest to the beneficiaries. In addition, the executive branch has determined that the common schools have already been compensated by the general fund due to the offsetting relationship between trust revenues and the general fund in funding public schools. However, most of the diverted revenues would have otherwise been added to trust investments, ultimately increasing the revenues available for distribution to the beneficiaries. For the common schools, prior to 2001 and after repayment of the coal tax loan used to purchase the mineral royalty income stream, the revenues would have been added to trust investments.

### **Inappropriately withheld common school revenues to cover administrative costs**

State law limits administration to 1 1/8 percent of the book value of all trusts, except capitol buildings. The DNRC then uses internal policy and procedures to calculate the amount each trust contributes to administration and deposits that amount from revenue sources into the trust administration account. During FY 2005 and 2006, certain trusts were unable to meet their administrative obligations based on DNRC cost allocation policies and state law. The deficit to the trust administration account was made up

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<sup>4</sup> 72-34-508, MCA

<sup>5</sup> This was a decision made by DNRC, but the statute requiring them to charge a fee has not been changed.

<sup>6</sup> Evans, Krista Lee, Financing the Administration of Montana's Trust Lands - A Review and Analysis of Federal Granting Legislation and Current Financing Methods, Interim study of the Environmental Quality Council, August 1, 2006

by a diversion of \$215,631 revenues from the common school trust. The supplemental appropriation does not include repayment of this amount or any corresponding interest.

## NEED FOR LEGISLATIVE REVIEW

It is the decision of the legislature to determine how the trusts are to be made whole from the diversions of revenue. The issue for the legislature is to determine the amount needed to make the trusts whole and the process in which it should be completed.

## How Much

As stated, trust statute stat that it is DNRC's fiduciary duty to return not only diverted but also accrued interest. The issue for the legislature is to determine an appropriate amount of interest. Diverted revenues most likely would have been deposited to the permanent trust fund. Figure 2 addresses total obligations through FY 2005 and minimal interest estimates.<sup>7</sup> The estimates were calculated based upon corresponding STIP rates and simple compounding. The amount does not include the amount of diversions made in FY 2006 or 2007 for administration of the Morrill Trust.

Figure 2			
Summary of Amounts Inappropriately Withheld From Trust Revenues with Interest			
	Morrill Diversions	Other Diversions	Allocation Issue
Common School		\$191,945	\$215,631
University of Montana		5	
Morrill Trust	\$507,643		
Montana State University - 2nd Grant		12,874	
Montana Tech		678	
State Normal School		5,388	
School for the Deaf & Blind		660	
State Reform		7,502	
Capital Building		<u>25,848</u>	
Diverted Revenue Total	507,643	244,900	215,631
Estimated Interest	351,887	1,400	1,000
Diverted Revenue & Interest	\$859,530	\$246,300	\$216,631

## How

A second issue for the legislature is to determine how the repayment of past diversions should occur. As stated, the executive is proposing a supplemental appropriation to DNRC to repay the trusts. However, transferring general fund to trust funds does not require appropriation authority as it is not leaving the treasury. If the legislature believes that these funds should be directly deposited to the trusts, legislation could accomplish this by simply directing transfers from the general fund to the appropriate trust. The proposed legislation could clearly outline why the transfer needs to occur.

If the legislature wished to provide one-time only spending authority to the beneficiaries for the amount diverted and any subsequent interest, an appropriation would be required. The legislature can choose to condition this money for a specific purpose or allow the beneficiaries to make that decision. This could be accomplished through HB 2 or a cat and dog bill.

<sup>7</sup> Legislative Audit Division, 2006

## **Other legislation**

As the result of an interim study, the Environment Quality Council is sponsoring legislation to clarify that administrative costs cannot be diverted from the Morrill Trust. A subsequent language appropriation for general fund to administer the Morrill trust is included in the Governor's Budget. The issues of cost accounting and fund management will potentially be addressed through legislation as requests for such are currently entered on the LAWS system.

## **SUMMARY**

The Legislative finance Committee may wish to:

- o Inform the executive of the need to increase the supplemental appropriation to repay all trust diversions with interest
- o Request legislation to utilize general fund transfers to the specific trusts for repayment of the past diversions and interest rather than a supplemental appropriation
- o Direct the appropriate subcommittees to add repayment amounts, including interest, to HB2 and condition the appropriation for a specific use